

Office of the State Auditor

Division of State Audit

Office of State Tax Commissioner Bismarck, North Dakota

Audit Report for the
Biennium Ended June 30, 2007
Client Code 127

Robert R. Peterson
State Auditor



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Transmittal Letter

February 14, 2008

The Honorable John Hoeven, Governor
Members of the North Dakota Legislative Assembly
The Honorable Cory Fong, Tax Commissioner

We are pleased to submit this audit of the Office of State Tax Commissioner for the biennium ended June 30, 2007. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Michael Schmitcke, CPA. Kristi Morlock and Paul Deede were the staff auditors. Cindi Pedersen, CPA, was the audit supervisor and Paul Welk, CPA, was the audit manager. Inquiries or comments relating to this audit may be directed to the audit manager by calling (701) 328-2320. We wish to express our appreciation to Commissioner Fong and his staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

Robert R. Peterson
State Auditor

Executive Summary

INTRODUCTION

The Office of State Tax Commissioner is responsible for collecting a variety of taxes used to fund government operations within the state of North Dakota.

These taxes include: sales and use tax; motor vehicle use and excise tax; individual and corporate income tax; business privilege tax; cigarette tax; tobacco tax; gross production and oil extraction tax; coal severance tax; coal conversion tax; estate tax; city lodging tax; city sales tax; city restaurant tax; transmission line tax; motor fuels and special fuels tax; alcohol tax; petroleum tariff; aircraft excise tax; telecommunications tax; performing rights tax; financial institutions tax; air transportation tax; and aviation fuel tax.

RESPONSES TO LAFRC AUDIT QUESTIONS

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies.

1. What type of opinion was issued on the financial statements?

Financial statements were not prepared by the Office of State Tax Commissioner in accordance with generally accepted accounting standards so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unqualified opinion was issued.

2. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Yes.

3. Was internal control adequate and functioning effectively?

Other than our finding addressing the "lack of background investigations" (see page 12), we determined internal control was adequate.

4. Were there any indications of lack of efficiency in financial operations and management of the agency?

No.

5. *Has action been taken on findings and recommendations included in prior audit reports?*

There were no recommendations included in the prior audit report.

6. *Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.*

Yes, a management letter was issued and is included on page 16 of this report, along with management's response.

LAFRC AUDIT COMMUNICATIONS

1. *Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.*

There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

2. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

The Office of State Tax Commissioner's financial statements do not include any significant accounting estimates.

3. *Identify any significant audit adjustments.*

Significant audit adjustments were not necessary.

4. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

None.

5. *Identify any serious difficulties encountered in performing the audit.*

None.

6. *Identify any major issues discussed with management prior to retention.*

This is not applicable for audits conducted by the Office of the State Auditor.

7. *Identify any management consultations with other accountants about auditing and accounting matters.*

None.

8. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

ConnectND Finance, Human Resource Management System (HRMS), Electronic Document Management System, Coal Severance Tax System, Coal Conversion Tax System, Data Entry System, State Tax Webfile System, Validation System, Withholding Webfile System, Financial Institutions Tax System, Income Tax Compliance Contract System, Oil and Gas Tax System, Federal/State Income Tax Electronic Filing System, Telecommunications Tax System, Property Tax Levy Audit System, GenTax Integrated Tax System, Accounting System, and Renter Refund System are high-risk information technology systems critical to the Office of State Tax Commissioner.

Background Information

The primary mission of the Office of State Tax Commissioner is to collect tax revenue required to be paid by law and necessary to fund the operation of state and local government, through the uniform and fair administration of North Dakota's tax laws. Accomplishment of this mandate requires the pursuit and achievement of several distinct goals simultaneously.

The Office of State Tax Commissioner is comprised of six divisions:

- Commissioner's Division
 - Legal Division
 - Fiscal Management Division
 - Operations Division
 - Income, Sales, and Special Taxes Division
 - Property and Utility Taxes Division
-

The Office of State Tax Commissioner is comprised of six separate divisions. The Commissioner's Division is the administrative center for the Department; the Legal Division provides legal advice and counsel to the Department and to the State Board of Equalization; the Fiscal Management Division performs accounting functions and collects delinquent taxes; the Operations Division is responsible for leading the Department's technology efforts and oversees the processing of tax returns; and the Income, Sales, and Special Taxes Division and Property and Utility Taxes Division administer different state taxes under the direction of the Tax Commissioner.

The North Dakota Office of State Tax Commissioner's final budget for the 2005-2007 biennium totals \$36.6 million. This represents a 72% increase compared to the 2003-2005 budget. The significant increase in the budget is related to the appropriation approved by the 2005 Legislative Assembly for the Integrated Tax System to be implemented by the Office of State Tax Commissioner. The state's general fund comprises \$22.5 million of the 2005-2007 budget.

More information about the agency can be obtained from the Office of State Tax Commissioner's home page at:

<http://www.nd.gov/tax/>

Audit Objectives, Scope, And Methodology

Audit Objectives

The objectives of this audit of the Office of State Tax Commissioner for the biennium ended June 30, 2007 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the most important areas of the Office of State Tax Commissioner's operations and is internal control adequate in these areas?
2. What are the significant and high-risk areas of legislative intent applicable to the Office of State Tax Commissioner and are they in compliance with these laws?
3. Are there areas of the Office of State Tax Commissioner's operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the Office of State Tax Commissioner for the biennium ended June 30, 2007 was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. To meet the objectives outlined above, we:

Audit Methodology

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report; and reviewed management's discussion and analysis of the financial statements.
- Performed detailed analytical procedures for expenditures and receipts.
- Tested samples of expenditures and accounts payable.
- Reviewed prior year audit workpapers.
- Interviewed appropriate agency personnel.
- Reviewed the Office of State Tax Commissioner's written plans and applicable manuals.
- Observed the Office of State Tax Commissioner's processes and procedures.
- Reviewed North Dakota Century Code chapter 57 and 2005 Session Laws.
- Conducted an application review of the significant information systems.
- Reviewed industry best practices through the use of Internet searches.
- Searched for recent studies or reports relating to the Office of State Tax Commissioner.

Management's Discussion And Analysis

The accompanying financial statements have been prepared to present the Office of State Tax Commissioner's revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

The following management discussion and analysis was prepared by the Office of State Tax Commissioner's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of this supplementary information to ensure it does not conflict with the knowledge we gained as part of our audit.

For the biennium ended June 30, 2007, operations of the Office of State Tax Commissioner were primarily supported by appropriations from the state's general fund. This is supplemented by special funding.

FINANCIAL SUMMARY

Revenues consisted primarily of sales and use, income, and natural resource taxes. Other revenues during the audited period included various other taxes: oil, gas, coal, fuel, and tobacco. Significant increases in natural resource taxes, sales and use taxes, and income taxes were the result of a strong economy and a surge in oil prices during the biennium. Additionally, there was a speed-up of collections due to withholding on distributive shares of partnership and small business income. This type of withholding is a new program which generated approximately \$12 million in fiscal year 2007. Total revenues were \$1,356,162,496 for the year ended June 30, 2007 as compared to \$1,217,088,127 for the year ended June 30, 2006.

Total expenditures for the Office of State Tax Commissioner were \$15,777,587 for the year ended June 30, 2007 as compared to \$17,417,993 for the prior year. Software expenditures decreased significantly in fiscal year 2007 as the initial purchase of the GenTax software was made in fiscal year 2006 for \$3 million. IT Service Contract expenditures increased significantly in fiscal year 2007 due to costs related to integrated tax system contractors and a maintenance agreement on the new GenTax system. Other expenditures remained fairly constant between fiscal years.

There were no adjustments to the original appropriation for the biennium ended June 30, 2007. During the 2005–2007 biennium, the Office of State Tax Commissioner entered into an agreement to develop and implement an Integrated Tax System. The funding to cover the costs of this project was through a loan in the amount of \$14 million. The Department also received appropriation authority for \$120,000 in federal grants; however no federal grant dollars were made available during the 2005–2007 biennium.

Financial Statements

STATEMENT OF REVENUES AND EXPENDITURES

	June 30, 2007	June 30, 2006
<u>Revenues and Other Sources:</u>		
General Sales and Use Taxes	\$ 489,519,094	\$ 433,091,347
Income Taxes	453,317,783	395,742,613
Natural Resource Taxes	229,091,975	209,300,557
Selective Sales and Use Taxes	163,858,490	155,958,711
Business Taxes	14,680,883	14,390,399
Integrated Tax System Loan	4,902,521	6,748,183
Other Taxes	700,000	700,000
Estate Taxes	27,801	1,086,192
Miscellaneous Revenue	63,949	70,125
Total Revenues and Other Sources	<u>\$1,356,162,496</u>	<u>\$1,217,088,127</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$ 6,574,833	\$ 6,376,105
Homestead Tax Credit Payments	2,196,497	2,210,408
Equipment	129,897	61,511
Major Operating Expenditures:		
Professional Services	4,587,083	3,594,701
Data Processing	1,080,283	1,202,472
Postage	463,706	303,480
Travel	142,993	144,898
Printing	94,930	95,541
Supplies	83,043	40,379
IT Communications	75,620	77,312
Professional Development	62,663	75,406
IT Software	51,642	3,036,176
Other Operating Expenditures	234,397	199,604
Total Expenditures and Other Uses	<u>\$ 15,777,587</u>	<u>\$ 17,417,993</u>

STATEMENT OF APPROPRIATIONS

For The Biennium Ended June 30, 2007

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 13,466,823	\$	\$ 13,466,823	\$ 12,950,824	\$ 515,999
Operating Expenses	4,613,329		4,613,329	4,169,071	444,258
Capital Assets	25,000		25,000	15,825	9,175
Homestead Tax Credit	4,500,000		4,500,000	4,406,905	93,095
Integrated Tax System	14,000,000		14,000,000	11,650,704	2,349,296
Totals	<u>\$ 36,605,152</u>	<u>\$</u>	<u>\$ 36,605,152</u>	<u>\$ 33,193,329</u>	<u>\$ 3,411,823</u>
Expenditures by Source:					
General Fund	\$ 22,485,152	\$	\$ 22,485,152	\$ 21,542,625	\$ 942,527
Other Funds	14,120,000		14,120,000	11,650,704	2,469,296
Totals	<u>\$ 36,605,152</u>	<u>\$</u>	<u>\$ 36,605,152</u>	<u>\$ 33,193,329</u>	<u>\$ 3,411,823</u>

Expenditures Without Appropriations Of Specific Amounts:

Insurance recoveries has a continuing appropriation authorized by NDCC section 54-44.1-09.1 (\$180 of expenditures for this biennium).

Internal Control

In our audit for the biennium ended June 30, 2007, we identified the following areas of the Office of State Tax Commissioner's internal control as being the most important:

Internal Controls Subjected To Testing

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls effecting the safeguarding of assets.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.
- Controls surrounding the computer-based:
 - electronic document management system
 - property tax levy audit system
 - renter refund system
 - telecommunication tax system
 - coal severance tax system
 - federal/state income tax electronic filing system
 - coal conversion tax system
 - accounting system
 - financial institutions tax system
 - income tax compliance contact tracking system
 - oil and gas tax system
 - data entry system
 - sales tax webfile system
 - validation system
 - withholding webfile system.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered significant. We concluded that internal control was not adequate noting a certain matter involving internal control and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the Office of State Tax Commissioner's operations or ability to record, process, summarize, and report financial data consistent with the assertions of management in financial statements. The reportable condition is described below. We also noted other matters involving internal control that we have reported to management of the Office of State Tax Commissioner in a management letter dated February 14, 2008.

LACK OF BACKGROUND INVESTIGATIONS

Finding 07-1

The Office of State Tax Commissioner does not perform background investigations for new hires that will have access to sensitive information such as tax returns, social security numbers, and bank account information.

The lack of these investigations makes it difficult to detect if new hires have a criminal history in areas such as identity theft, embezzlement, fraud, etc.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control – Integrated Framework dictates that a background investigation be completed for employee candidates, particularly with regard to prior actions or activities considered unacceptable.

Audit Recommendation and Agency Response

Recommendation:

We recommend the Office of State Tax Commissioner develop a policy that, at a minimum, would require background investigations to be done for candidates being considered for full-time equivalent positions with duties that include: accounting; financial oversight; access to personal information; and access to tax information.

Office of State Tax Commissioner Response:

The Office of State Tax Commissioner agrees and will seek legislative authority to utilize the Bureau of Criminal Investigation to provide a statewide and nationwide criminal history record as provided under NDCC §12-60-24(2).

Compliance With Legislative Intent

In our audit for the biennium ended June 30, 2007, we identified and tested the Office of State Tax Commissioner's compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

Legislative Intent Subjected To Testing

- Proper collection and deposit of taxes and fees, including:
 - Inspection Fees (NDCC 19-10)
 - Job Training (NDCC 52-02.1)
 - Township Highway Aid Fund (NDCC 54-27)
 - Homestead Tax Credits (NDCC 57-02)
 - Telecommunication Tax (NDCC 57-34)
 - Financial Institutions Tax (NDCC 57-35.3)
 - Cigarette/Tobacco Tax (NDCC 57-36)
 - Individual/Corporate Income Tax (NDCC 57-38)
 - Sales and Use Tax (NDCC 57-39.2, 57-40.2)
 - Motor Vehicle Fuel Tax (NDCC 57-43.1)
 - Special Fuels Tax (NDCC 57-43.2)
 - Aviation Fuel (NDCC 57-43.3)
 - Oil Gross Production Tax (NDCC 57-51)
 - Gas Production Tax (NDCC 57-51)
 - Oil Extraction Tax (NDCC 57-51.1)
 - Coal Conversion Tax (NDCC 57-60)
 - Coal Severance Tax (NDCC 57-61)
- Compliance with limitation on a financing agreement for the integrated tax system (House Bill 1006, section 6 of the 2005 Session Laws).
- Compliance with the requirement to accompany and advise the Streamlined Sales Tax Governing Board and the Local Advisory Council (House Bill 1042, section 1, of the 2005 Session Laws).
- Implementation of a treasury offset program (House Bill 1107, section 1 of the 2005 Session Laws).
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with appropriations and related transfers (2005 North Dakota Session Laws chapter 6).
- Compliance with OMB's Purchasing Procedures Manual.
- Travel-related expenditures are made in accordance with OMB policy and state statute.
- Adequate blanket bond coverage of employees (NDCC section 26.1-21-08).
- Compliance with fixed asset requirements including record keeping and surplus property.
- Compliance with payroll related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.

The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. Thus, we concluded there was compliance with the legislative intent identified above. However, we noted a certain immaterial instance of noncompliance that we have reported to management of the Office of State Tax Commissioner in a management letter dated February 14, 2008.

Operations

This audit did not identify areas of the Office of State Tax Commissioner's operations where we determined it was practical at this time to help to improve efficiency or effectiveness.

Management Letter (Informal Recommendations)

February 14, 2008

The Honorable Cory Fong
Tax Commissioner
Office of State Tax Commissioner
600 E. Boulevard Avenue
Bismarck, ND 58505

Dear Mr. Fong:

We have performed an audit of the Office of State Tax Commissioner for the biennium ended June 30, 2007, and have issued a report thereon. As part of our audit, we gained an understanding of the Office of State Tax Commissioner's internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted certain conditions we did not consider reportable within the context of your audit report. These conditions relate to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendations to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if these recommendations have been implemented, and if not, we will reconsider their status as non-reportable conditions.

The following present our informal recommendations.

LEGISLATIVE INTENT

Informal Recommendation 07-1: We recommend the Office of State Tax Commissioner obtain an adequate level of blanket bond coverage.

GENERAL

Informal Recommendation 07-2: We recommend the Office of State Tax Commissioner establish a fraud risk assessment on a comprehensive and recurring basis which would include ensuring that control activities are designed and documented to ensure that each significant fraud exposure identified during the risk assessment process has been adequately mitigated, and that the control activities addressing each of the identified fraud risks has been adequately tested by management.

Informal Recommendation 07-3: We recommend the Office of State Tax Commissioner develop a code of ethics and code of business conduct and ensure that employees acknowledge their receipt and reading of the code.

Informal Recommendation 07-4: We recommend the Office of State Tax Commissioner establish and administer a policy to prevent and detect abuse of electronic communication devices in accordance with IT Standard S004-02.

Management of Office of State Tax Commissioner agreed with these recommendations.

I encourage you to call myself or the audit manager at 328-2241 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,

Michael W. Schmitcke, CPA
Auditor in-charge